Supreme Court, U.S.
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No. 95-

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1995

PHILIP MORRIS INCORPORATED,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR WRIT OF CERTIORARI

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March 6, 1996

QUESTION PRESENTED

Whether the Second Circuit should have followed the Sixth Circuit in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964), and held that income realized by petitioner on the repayment of certain foreign currency borrowings constituted "income by reason of the discharge of indebtedness" which qualified for tax deferral under I.R.C. section 108(a), notwithstanding this Court's intervening decision in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), which held that income realized by a bank on its early repayment of domestic certificates of deposit did not so qualify.

RULE 29.6 STATEMENT

The parent company of petitioner is Philip Morris Companies Inc., a publicly-owned corporation. Petitioner does not have any subsidiaries that are not wholly owned.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported at 71 F.3d 1040 (1995), and is reproduced in the Appendix at pages 3a-14a. The opinion of the United States Tax Court is reported at 104 T.C. 61 (1995), and is reproduced in the Appendix at pages 18a-38a.

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on December 8, 1995. This Court has jurisdiction under 28 U.S.C. section 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 61(a)(12), 108(a) and 1017(a) of the Internal Revenue Code applicable to the years at issue are set forth in the Appendix at pages 40a-41a.[1/] Section 22(b)(9) of the Internal Revenue Code of 1939 is set forth in the Appendix at pages 39a-40a.

STATEMENT OF THE CASE

A. Background

Since this Court's landmark decision in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), it has been clear that the repayment of a debt will give rise to taxable income if the amount repaid is less than the amount borrowed. When the debt involves foreign currency, special rules apply because foreign currency is treated as property, not money, in the hands of a U.S. taxpayer. (A. 8a.)

A borrower of foreign currency is required to account for the transaction as if it were a U.S. dollar loan. The borrowed currency must be translated into dollars at the time of the borrowing in order to determine the U.S. tax consequences that flow from repayment. (Id.) As explained by the Second Circuit below, this means that "a taxpayer may satisfy a foreign currency loan with the exact sum of foreign

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[1/] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect during the years at issue (the "Code").

currency stipulated and yet realize a gain or loss when the foreign currency is translated into U.S. dollars." (Id.)

As the Second Circuit also noted, prior to the decision of this Court in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), the tax treatment of income realized on the repayment of a foreign currency borrowing was well-settled. Such income was characterized as ordinary income under section 61(a)(12) ("income from discharge of indebtedness") rather than as capital gain. (A. 11a, citing Gillin v. United States, 423 F.2d 309, 314 (Ct. Cl. 1970).) As so characterized, the income was eligible for the benefit of tax deferral under section 108(a), as income realized "by reason of the discharge of indebtedness."[2/] (A. 9a, citing Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520, 523 (6th Cir. 1964).)

[2/] During the years here at issue, section 108(a)(1) provided in pertinent part:

> "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if-- * * *
>
> (C) the indebtedness discharged is qualified business indebtedness."

Tax deferral occurs under section 1017(a) through a reduction in the cost basis of the taxpayer's depreciable assets and other property equal to the amount of the "discharge of indebtedness income."

In Centennial, discussed more fully below, this Court denied tax deferral under section 108(a) for income realized by a bank on the early repayment of domestic certificates of deposit because, when the withdrawal occurred, no release was secured from the depositors with respect to any portion of the bank's repayment obligation.

B. Petitioner's Foreign Currency Borrowings

During the early 1980s, petitioner entered into six foreign currency borrowings -- three in Swiss francs, one in Deutsche marks and two in British pounds sterling. In the case of the Swiss franc and Deutsche mark borrowings, petitioner immediately converted the foreign currency received into U.S. dollars for various business uses, including the repayment of short-term dollar debt. (A.19a-23a.) The major advantage of acquiring U.S. dollars in this manner was the substantial interest cost savings available at the time because of lower foreign interest rates. Petitioner used the pound sterling borrowings to pay for certain machinery acquired abroad. (A. 21a-22a.)

Due to favorable market conditions, petitioner chose to prepay each of the Swiss franc borrowings in 1983 (A. 19a-21a), and to prepay a portion of the Deutsche mark borrowing in 1984. (A. 22a-23a.) Petitioner paid regular semi-annual installments on each of its pound sterling borrowings in 1983 and 1984.

With respect to each of petitioner's six borrowings, the U.S. dollar value of the foreign currency involved had declined between the time of the borrowing and the time of repayment. Petitioner therefore realized income on each of its repayments, notwithstanding that the same number of

foreign currency units originally borrowed were repaid. For example, on November 24, 1980, petitioner borrowed 100 million Swiss francs ("SF") from Union Bank of Switzerland, repayable with interest on December 1, 1987. The proceeds of the borrowing were converted into U.S.$58,126,693 on the day they were borrowed. (A. 19a-20a.) On September 1, 1983, petitioner prepaid the SF100 million principal plus accrued interest, when the value of SF100 million had declined to U.S.$45,714,286. (Id.)

In its federal income tax returns for 1983 and 1984, petitioner elected under section 108(a) to defer reporting the income it had realized on the repayment of its borrowings and, as required under section 1017(a), to reduce the cost basis of its depreciable assets by the amount of the income so deferred. (A. 23a.)

Respondent rejected petitioner's elections under sections 108(a) and 1017(a), restored the deferred amounts to current gross income, and determined deficiencies in petitioner's income tax of more than $7.8 million with respect to such amounts for the taxable years 1983 and 1984. (A. 16a, 23a.)[3/]

[3/] For taxable years beginning after December 31, 1986, the U.S. tax consequences of foreign currency borrowings such as those here involved are governed by section 988. That section generally treats as currently taxable ordinary income any income realized on the repayment of a foreign currency borrowing entered into in connection with a trade or business.

C. Proceedings Below

Petitioner brought an action in the United States Tax Court for a redetermination of the deficiencies. The Tax Court (Tannenwald, J.) held for respondent. The court reasoned that under this Court's decision in Centennial, petitioner's income was not realized "by reason of the discharge of indebtedness" within the meaning of section 108(a) because, when petitioner repaid its borrowings, it did not secure releases from its creditors with respect to any portion of its repayment obligations. The Tax Court concluded that the Sixth Circuit's decision in Kentucky & Indiana Terminal R.R., on which petitioner had relied, had been "sapped of its vitality" by Centennial. (A. 34a.)

Petitioner appealed to the United States Court of Appeals for the Second Circuit. That Court (Winter, J.) agreed with the Tax Court that Centennial controlled the outcome of the instant case, while acknowledging that "[u]nder the only court of appeals decision directly on point [Kentucky & Indiana], the foreign exchange transactions in this case would each have been considered a discharge of indebtedness, and the income produced would have been 'by reason of' that discharge." (A. 9a (citation omitted).)

REASONS FOR GRANTING THE WRIT

A. The Second Circuit's Dilemma

The Second Circuit opinion virtually requests a grant of certiorari because of its conflict with the Sixth Circuit in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964). That conflict is due entirely to the uncertainty created by this Court's intervening decision in

United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991).

The Second Circuit read Centennial as holding that there can be no "discharge of indebtedness" within the meaning of section 108(a) where the debtor does not secure from its creditor a forgiveness or release from a pre-existing payment obligation, something petitioner did not secure here. Despite its holding, however, the Second Circuit voiced the following concerns:

1. Centennial did not expressly address foreign currency transactions and may not have intended to overturn existing case law, such as Kentucky & Indiana, involving foreign currency borrowings. (A. 11a-13a.)

2. The instant case is similar to United States v. Kirby Lumber Co., 284 U.S. 1 (1931), the landmark case recognized (and reaffirmed in Centennial) as involving a classic example of "discharge of indebtedness income." (A. 13a.)

3. Petitioner's situation "appears to be just the type of situation that Congress sought to ameliorate" through the tax-deferral mechanism of section 108(a). (Id.)

Notwithstanding these expressed concerns, the Second Circuit nevertheless believed it had no choice but to conclude that --

> we are not at liberty to entertain the taxpayer's position in light of the Supreme Court's clear holding in Centennial Savings Bank that Section 108(a) requires a forgiveness or release of an obligation of the

> underlying debt to constitute the requisite discharge of indebtedness.

(Id.)

B. The Sixth Circuit Conflict

In Kentucky & Indiana, the Sixth Circuit had considered the precise question here presented -- whether income realized on the repayment of a foreign currency borrowing was eligible for tax deferral as "income of the taxpayer attributable to the discharge of any indebtedness" under section 22(b)(9) of the 1939 Internal Revenue Code (the predecessor of section 108(a)). The taxpayer had sold British pound sterling bonds to the public at a time when £1 equalled U.S.$4.86. Forty years later, the taxpayer repurchased a number of its bonds in the open market at a cost of less than $2.80 per £1 of face value (the level to which the pound had been officially devalued). There was no indication that the taxpayer had secured releases from its bondholders.

The IRS conceded that the taxpayer had income from the discharge of indebtedness, but only with respect to the difference between the repurchase price paid for the bonds and $2.80 per £1 of face value. The balance of the taxpayer's income was claimed to be gain from currency speculation.

The Sixth Circuit held that the full amount of income realized by the taxpayer was income attributable to the discharge of indebtedness. The court noted that tax deferral under section 22(b)(9) represented the Congressional response to this Court's decision in Kirby Lumber. It concluded that to deny tax deferral to the full extent of the income realized

on the bond repurchases "would defeat the underlying purpose of Section 22(b)(9)." 330 F.2d at 524.

As the Second Circuit observed below, prior to Centennial, the Sixth Circuit's decision in Kentucky & Indiana was generally accepted as governing law in the area of foreign currency borrowings. (A. 11a.) The Second Circuit reluctantly concluded, however, that this Court's decision in Centennial, "while not expressly addressing foreign exchange transactions or the continued viability of Kentucky & Indiana, effectively undermined the latter decision." (Id.)

C. This Court's Holdings in *Centennial Savings Bank* and *Kirby Lumber*

While the conflict between the Second and Sixth Circuits would be reason enough for a grant of certiorari, there is an additional dimension to the instant case. This Court's intervening decision in Centennial Savings Bank has created the uncertainty that produced the conflict.

In Centennial, a bank that issued certificates of deposit had agreed in advance with its depositors that on any given date before a certificate matured, the amount to be repaid would be the principal amount of the deposit plus accrued interest, less a stipulated penalty imposed on the depositor for early withdrawal. This Court held that section 108(a) did not apply to the bank's penalty income because such income was not realized "by reason of the discharge of indebtedness."

According to this Court, a debt is not "discharged" within the meaning of section 108(a) unless the debtor secures a release or forgiveness from its creditor with respect

to some portion of its repayment obligation. 499 U.S. at 580-81. In Centennial, the amount paid by the bank on early withdrawal represented the predetermined amount owed to the depositor on that day. There was thus no remaining payment obligation to be released or forgiven, and hence no "discharge" of any portion of the bank's indebtedness.

In the course of its opinion in Centennial, this Court reaffirmed its landmark decision in Kirby Lumber. That case had involved an open market purchase of dollar-denominated bonds at a discount from their face value. It was the first decision by this Court to hold that a debtor realized income in such a situation. The rationale of Kirby Lumber was explained in Centennial as follows:

> The tax deferral mechanism in §108 is designed to mitigate the effect of treating the discharge of indebtedness as income. See 26 U.S.C. §61(a)(12) (1982 ed.) ("gross income . . . includ[es] . . . income from discharge of indebtedness"). Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates. See United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); Commissioner v. Jacobson, 336 U.S. 28, 38

(1949); see also Commissioner v. Tufts, 461 U.S. 300, 307, 310-311, n.11 (1983).

499 U.S. at 582 (emphasis in original).

Since Kirby Lumber involved an open market repurchase of bonds, there was no mention of (and there would have been no occasion for) the securing of a release or forgiveness by the debtor from its bondholders at the time of repayment. Public bondholders are not likely to know who the open market purchasers of their bonds might be, let alone that the purchaser might be the debtor itself. Yet, when a debtor acquires its own bonds at a discount, it is clear from the very nature of the transaction that a portion of the underlying debt will never be paid because the debt has been extinguished. It is therefore appropriate to treat the repurchase as giving rise to income.

As noted by the Sixth Circuit in Kentucky & Indiana, the decision in Kirby Lumber led Congress to take remedial action. Section 22(b)(9) (the predecessor of section 108(a)) was first enacted in 1939 for the specific purpose of encouraging corporations in weak financial condition (primarily the railroads) to repurchase previously issued bonds that were then selling below par value in the open market. H.R. Rep. No. 855, 76th Cong., 1st Sess. 4-5 (1939); S. Rep. No. 1631, 77th Cong., 2d Sess. 77 (1942). By granting tax deferral under section 22(b)(9) to "income of the taxpayer attributable to the discharge of any indebtedness," Congress sought to remove Kirby Lumber as an impediment to such transactions.

D. The Impact of *Centennial Savings Bank*

Centennial has introduced enormous confusion into the foreign currency area. Although it did not in any way consider the unique tax treatment accorded foreign currency borrowings, both the Tax Court and the Second Circuit considered Centennial to be controlling authority on the issue here presented. Yet, as the Second Circuit acknowledged, given the narrow question presented in Centennial, there is serious doubt whether this Court's holding was intended to apply to foreign currency borrowings.

That doubt is strongly reinforced by the Second Circuit's determination that petitioner's repayments were within the intended scope of section 108(a) during the years at issue. As the court observed, petitioner "has taken advantage of favorable market conditions to eliminate preexisting debt by a payment that fulfills the terms of the original debt but is functionally less than that debt." (A. 13a.) According to Judge Winter:

> It therefore appears to be just the type of situation that Congress sought to ameliorate by "establish[ing] the tax-deferral mechanism in § 108 so that the prospect of immediate tax liability would not discourage businesses from taking advantage of opportunities to repurchase or liquidate their debts at less than face value." Centennial Savings Bank, 499 U.S. at 582-83 (citations omitted).

(Id.)

In Centennial, this Court speculated that "Congress could easily have concluded that only debtors seeking a release from a pre-existing repayment obligation need or deserve the tax break conferred by § 108." 499 U.S. at 583. As the Second Circuit's analysis suggests, however, the legislative history of section 22(b)(9) actually points in a totally different direction.

As noted, the tax-deferral provision was originally enacted to provide the railroads and other companies in financial distress with an incentive to repurchase their bonds at a discount on the open market without incurring immediate tax liability. H.R. Rep. No. 855, 76th Cong., 1st Sess. 4-5 (1939); S. Rep. No. 1631, 77th Cong., 2d Sess. 77 (1942). It is extremely unlikely that a debtor in distress would seek to negotiate releases from its bondholders when it entered the public market to repurchase its bonds at the lowest prices obtainable. That almost certainly explains the complete absence of any indication in the legislative history of section 22(b)(9) that "only debtors seeking a release" were viewed by Congress as needing or deserving the benefit of tax deferral.

In fact, the pertinent legislative history strongly suggests that Congress intended that the requisite "discharge of indebtedness" would occur whenever there was payment by the debtor of an amount less than the face value of the debt, coupled with a resulting extinguishment of the debt.[4/]

[4/] In explaining how section 22(b)(9) was intended to operate, the 1939 House Ways and Means Committee Report provides an example of a taxpayer with two bond issues outstanding. The Report states: "Both issues are discharged by payment less than the face value of the (continued...)

Nothing in the subsequent history of section 108(a), as it was expanded and amended over the years, suggests that Congress ever intended to adopt a narrower meaning of the term for purposes of allowing tax deferral on the repayment of a debt. See, e.g., S. Rep. No. 1631, 77th Cong., 2d Sess. 77-78 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A28 (1954); S. Rep. No. 1035, 96th Cong., 2d Sess. 20 (1980).

In light of the origin and history of section 108(a), it is wholly illogical and inappropriate to deny petitioner the benefit of that provision. Petitioner was required to account for its borrowings as if they were U.S. dollar borrowings. As the Second Circuit explained, a debtor's repayment of borrowed foreign currency at a time when it has declined in dollar value "fulfills the terms of the original debt but is

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[4/] (...continued)
obligations." H.R. Rep. No. 855, 76th Cong., 1st Sess. 24 (1939) (emphasis added).

The House Report also describes the consequences of repurchasing debt obligations for property rather than cash. "Whenever a discharge of indebtedness is accomplished by the transfer by the debtor of property in kind...." Id. at 25 (emphasis added).

The foregoing statements clearly indicate that Congress did not contemplate that a debtor must invariably secure a release or forgiveness from its creditor in order to achieve a "discharge" of its indebtedness. Bonds could be "discharged by payment" at less than face value. A "discharge" could be "accomplished" by the transfer of property in kind. See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. A28 (1954) ("[T]he general rule to be followed [is] that all discharges of indebtedness should be included in gross income with certain listed exceptions. The general rule pertains to factual situations such as those involved in United States v. Kirby Lumber Company . . .").

functionally less than that debt." (A. 13a.) Because the amount of the repayment is functionally less than the original debt in dollar terms, the debtor is deemed to realize income. But because the repayment literally fulfills the terms of the original debt when expressed in foreign currency, there is no occasion for the debtor to secure a release from its creditor. Yet, the elements of a "discharge of indebtedness" are all in place because it is clear from the very nature of the transaction, just as it was in Kirby Lumber, that the debtor will have no further payment obligation with respect to the unpaid dollar balance of the loan.

This Court's reaffirmance of Kirby Lumber in Centennial would appear to reflect an awareness of the need for some flexibility in applying the "discharge" rules, i.e., by inferring a release or forgiveness, if one is necessary, in appropriate situations. Otherwise, Kirby Lumber itself -- the very case that led to the enactment of what is now section 108(a) -- would fail to satisfy the "discharge" requirements of that section.[5/]

[5/] The Tax Court below reached the rather unusual conclusion that under Centennial, income realized on the repayment of a foreign currency borrowing could not constitute "income by reason of the discharge of indebtedness" within the meaning of section 108(a), but such income might nevertheless constitute "income from discharge of indebtedness" within the meaning of section 61(a)(12). (A. 35a; emphasis added.)

That cannot be the law. Sections 61(a)(12) and 108(a) are in pari materia. See Centennial, 499 U.S. at 582. Also, compare Centennial, 499 U.S. at 579 with 499 U.S. at 580.

The conclusion reached by the Tax Court undoubtedly reflects the confusion introduced into this area by Centennial's holding and its reaffirmation of Kirby Lumber.

A similar flexibility in applying section 108(a) is required when foreign currency borrowings are at issue. Otherwise, Centennial produces an anomalous result -- using dollars to determine whether income is realized on repayment, but using foreign currency to determine whether the income so realized is eligible for tax deferral under section 108(a). Such a result cannot be justified on the basis of the relevant statutory language or its legislative history.

* * *

This Court in Centennial almost certainly did not consider the implications of its holding on foreign currency borrowings. That decision has caused significant confusion and a square conflict between the Second and Sixth Circuits on the question here presented.

Three times in the past eight years, this Court has rendered opinions in the Federal income tax area for the purpose of clarifying its own prior pronouncements in order to provide proper guidance to the lower courts. Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988) (clarifying the scope of Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955)); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, (1992) (clarifying the scope of Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971)); and Commissioner v. Schleier, 115 S. Ct. 2159 (1995) (clarifying the scope of United States v. Burke, 504 U.S. 229 (1992)).

The instant case presents another such situation. While the new rules adopted by Congress in 1986 will preclude the result reached in Kentucky & Indiana in many

cases,[6/] the issue here involved remains an important one. Multinational corporations such as petitioner must have the question resolved for all taxable years still under audit in which income was realized on the repayment of their foreign currency borrowings. In addition, any individual who engages in such a borrowing for nonbusiness reasons (e.g., a corporate employee assigned to an overseas post who acquires a residence and finances the acquisition with a local mortgage) remains eligible for the tax deferral benefits of section 108(a) in the event of insolvency. Cf. Quijano v. United States, 76 AFTR2d (P-H) 7739 (D. Me. 1995).

Given the conflict between the Circuits, as well as the confusion caused by Centennial and the continuing significance of the issue, review of the instant case by this Court is both necessary and appropriate.

[6/] See supra note 3; Staff of the Jt. Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, 1098 (Comm. Print 1987) ("The [new Section 988] reverses the result in the Kentucky & Indiana Terminal Railroad case.").

* * * * *

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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